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# Revising Financial Sector Policy in Transitional Socialist Economies

## Will Universal Banks Prove Viable?

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In the transitional period, regulatory policy should assign to banks primary responsibility for achieving fundamental objectives: establishing and maintaining the integrity of the payments system and the safety of depositors' savings, and ensuring that money markets function. It should encourage nonbank financial institutions to pursue other objectives such as the privatization and restructuring of enterprises.

This paper — a product of the Financial Policy and Systems Division, Country Economics Department — is part of a larger effort in the department to study financial reform in transitional socialist economies. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Karin Waelti, room N9-043, extension 37664 (November 1992, 24 pages).

Focusing on efforts under way, in most transitional socialist economies, Scott questions whether the banks emerging in the new policy framework will prove viable or be supervisable. He offers a model of financial sector structure designed to foster the development of a sound banking system.

In describing the environment in which financial policy is being revised, Scott notes that the extraordinary challenges policymakers face might influence the shape of policy. He is concerned that policies to promote a sound banking system might be overlooked or sacrificed.

Fundamental policy objectives, says Scott, are those important to long-term economic well-being. These include establishing and maintaining the integrity of the payments system and the safety of depositors' savings, and ensuring that money markets function. Transitional objectives, on the other hand, relate primarily to the immediate task of privatizing and restructuring enterprises. Policymakers must balance inherent conflicts between the two kinds of objectives while promoting the achievement of both.

Many transitional socialist economies, he observes, adopt a policy framework that envisions universal banking. He assesses the consequences of the immediate emergence of financial conglomerates, or universal-type banks, and questions whether — in the face of limited managerial and institutional capability, limited capability for supervising financial markets, and extraordinary financial market risks — financial conglomerates simultaneously pursuing conflicting fundamental and transitional objectives will prove viable.

Scott advocates delaying the emergence of financial conglomerates until skills are developed and market turmoil subsides. In the transitional period, regulatory policy would assign to banks primary responsibility for achieving fundamental objectives, and would encourage nonbank financial institutions to pursue transitional objectives. Policy should promote financial soundness in the banking system, to control the potential costs to government of achieving its fundamental objectives.

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**REVISING FINANCIAL SECTOR POLICY  
IN TRANSITIONAL SOCIALIST ECONOMIES:  
WILL UNIVERSAL BANKS PROVE VIABLE?**

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**This paper reflects concepts developed by many individuals, including Marie-Renee Bakker, Jerry Caprio, Hugo Colje, Stig Danielsson, Olivier Godron, Joaquin Gutierrez, Ross Levine, Millard Long, Vince Polizatto, Andrew Sheng, Alfredo Thorne, Samuel Talley, Sven Vernerson and Dimitri Vittas. The synthesis and presentation is the author's. Special thanks to Ross Levine, Millard Long and Andrew Sheng for their comments.**

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## **I. SUMMARY**

**This paper focuses on efforts underway in most TSEs to revise and update financial sector regulatory policy. It questions whether the banks which emerge under the new policy framework will be supervisable or prove viable. The paper offers a model of financial sector structure designed to foster the development of a sound banking system.**

**Section II of this paper briefly summarizes the environment in which financial sector policy is being revised. It notes that the extraordinary challenges facing policymakers may significantly influence the shape of the new policy framework, and raises the concern that policies designed to promote a sound banking system may be overlooked or sacrificed.**

**Section III examines in more detail the diverse objectives of policymakers, grouping those objectives into two broad categories: fundamental objectives and transitional objectives. Fundamental objectives, those which are important to long run economic well-being, include establishing and maintaining the integrity of the payments system and the safety of depositors' savings, and ensuring the functioning of the money markets. Transitional objectives, on the other hand, primarily relate to the immediate task of enterprise restructuring and privatization. A key challenge for policymakers is to design a policy framework that balances inherent conflicts among and between these fundamental and transitional objectives, and thereby promotes achievement of both sets of objectives.**

**Section IV observes the tendency in many TSEs to adopt a policy framework envisioning universal banking, and assesses the consequences of the immediate emergence of financial conglomerates, or universal-type banks. It questions the potential viability of financial conglomerates pursuing conflicting objectives in the context of limited managerial and institution capacity, limited capacity for financial market supervision, and extraordinary financial market risks. A policy framework built around such institutions may not achieve policymakers' objectives.**

**Section V offers an alternative policy framework. It advocates delaying the emergence of financial conglomerates until skills are developed and market turmoil subsides. Over this transitional period, regulatory policy would assign to banks primary responsibility for**

achieving fundamental objectives, and would promote the role of non-bank financial institutions in pursuit of transitional objectives. Policy would be designed to promote the financial soundness of the banking system so as to control the potential costs to government of assuring achievement of its fundamental objectives.

## **II. BACKGROUND**

Policymakers in European and Eurasian TSEs are confronted with complex challenges regarding both the financial and real sectors of the economy. The financial sector typically is dominated by a limited number of large state-owned banks. The financial condition of the banks largely reflects that of the real sector, which requires restructuring, debt relief and new investment. Governments wish to transfer ownership of many of these financial institutions and enterprises to the private sector over time, and the privatization process is entangled in the process of organizational and financial restructuring.

While the authorities are attempting to deal with restructuring and privatization, they are at the same time completely overhauling financial sector legislation. New laws relating to banking, central banking, securities markets, investment funds, and insurance will sharply redefine the regulatory policy framework. Supervisory bodies are being established or reoriented, and are developing regulations which further redefine the policy framework.

In establishing the new policy framework, policymakers are striving to achieve divergent, often conflicting, objectives. Prominent among them are those dealing with the challenges of administering and financing the transition. For example, in the face of insufficient fiscal resources and limited available private capital, the authorities may directly or indirectly tap the state-owned banks for needed finance. These banks may be asked to play significant roles in the enterprise restructuring process, and in enterprise privatization. More generally, banks may be called upon to take the lead in financing and administering the development of the capital markets. As the challenges of transition are likely to be viewed as priorities by policymakers, there is a risk that transitional objectives such as these will be major determinants of the emerging policy framework. More fundamental objectives geared toward fostering a sound banking system which lays a foundation for higher and more stable long run growth may be overlooked or sacrificed.

### **III. OBJECTIVES OF BANK REGULATORY POLICY**

**Regulatory policies governing banking systems reflect diverse and conflicting objectives. It is common for countries to adopt certain fundamental objectives relating to the role of banks in a modern economy. Beyond these, governments frequently adopt ancillary objectives, such as those directing finance to certain sectors or enterprises. In the TSE context, these ancillary objectives often relate to the challenges of transition.**

#### **Fundamental Objectives and Financial Soundness**

**The achievement of certain fundamental objectives of bank regulation can serve as a foundation for economic stability and growth. These fundamental objectives include:**

- o Safeguard depositors' funds and thus promote confidence in the financial system;**
- o Preclude systemic threats to the payments system;**
- o Ensure orderly implementation of monetary policy; and**
- o Promote efficient intermediation.**

**In the transitional environment, banks are the major deposit-takers, are the only participants in the payments system, and are the dominant players in the money markets, on which implementation of monetary policy depends. As such, the authorities can assure achievement of many of the fundamental objectives by ensuring the financial soundness of the banking system. A financially sound banking system is one comprised predominately of solvent and liquid banks. Depositors' funds are safeguarded by the ability of the system to absorb the losses of banks that become insolvent. The ability of the system to settle its obligations eliminates potential threats to the payments system and the money markets. When the banking system is financially sound, the need for extraordinary intervention to support the solvency or liquidity of banks is minimized. Required interventions can be affected within the normal operating authority and capability of the central bank or deposit protection scheme.**

Financial soundness is jeopardized when the risks incurred by banks exceed that which their capital supports. Usually excessive risks arise from the process of intermediation; resources are poorly allocated and loans are not repaid. Absent systemic financial soundness, the system is unable to meet the collective obligations of its members to depositors and money market creditors. The payments system and the money markets can be comprised. Moreover, distorted incentives in the relatively larger number of troubled banks will threaten the overall efficiency of intermediation.

When the banking system lacks the financial capacity to meet its collective obligations, achievement of many of the fundamental objectives can only be assured through extraordinary intervention; the authorities must step in to fulfill the obligations of failing banks. In practice, governments or central banks almost invariably fulfill failing banks' obligations to other financial institutions for payments system settlements, including the settlement of maturing money market transactions, in order to prevent the failure of an individual bank triggering systemic collapse. And with only somewhat less frequency, payments are made to depositors on behalf of failing banks. Lacking systemic financial soundness, required interventions can be frequent and sizeable.<sup>1</sup>

### **Transitional Objectives**

Policymakers understandably pursue objectives in addition to those noted above. Some transitional objectives may be consistent with the financial soundness of the banking system, but others may not be so. Among the most common, often conflicting transitional objectives are the following:

- o Cease financing and liquidate non-viable firms;**
- o Continue to provide quasi-fiscal finance to less than credit-worthy borrowers to minimize unemployment;**

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<sup>1</sup> The authorities may attempt to avoid a permanent transfer of resources by supporting the liquidity of failing banks. But with limited exception, what is intended to be temporary liquidity support evolves into permanent solvency support, and results in a higher long run cost.



- o Work with enterprise managers to develop restructuring proposals, and support those proposals by writing-off and restructuring enterprise debts and lending for new investment;
- o Participate in the privatization of enterprises by financing the purchase of enterprises by the private sector, acquiring enterprises on behalf of customers (e.g. via mutual funds), acquiring enterprise equities as portfolio investments, and underwriting share offerings; and
- o Supply the capital base necessary to support development of the capital markets industry, and perhaps the insurance industry.

Many of these transitional objectives involve capital market activities for which there is little recent precedent in most TSEs.

### **Balancing Conflicting Objectives**

In designing financial sector policy, policymakers must reconcile the manner in which conflicting objectives are to be achieved in the context of a modernized financial sector structure. To avoid destabilizing interventions, policymakers must balance the desired role of banks in fulfillment of fundamental and transitional objectives with the goal of maintaining the financial soundness of the banking system. A key factor in making this tradeoff is the role that bank supervision can be expected to play. Supervision might be relied upon to ensure the financial soundness of the system regardless of the risks inherent in the policy framework. But experience demonstrates that bank supervision often is excessively relied upon to preclude problems whose root is poor or overly-ambitious policy.

In the TSE environment, bank supervision will evolve slowly, and must not be relied upon as the means by which financial soundness will be maintained. In the absence of effective supervision, it is the policy framework itself that must be designed to offer a reasonable expectation of engendering a financially sound banking system. The policy tradeoffs involved might imply sacrificing some price efficiency in intermediation (a fundamental objective) in order to support higher risk-adjusted returns that can contribute to bank

financial soundness. Further, they might imply limiting the role of banks in riskier financial market activities, many of which are inherent in the transitional objectives.

#### **IV. FINANCIAL SECTOR STRUCTURE**

The new policy framework will largely reshape financial sector structure in TSEs. It will define permissible types of financial institutions, determine the range of activities in which each type can engage, and govern ownership and control of financial institutions. What emerges as the new structure of the banking and financial systems will significantly influence the means by which the fundamental and transitional objectives of bank regulation are to be achieved.

Financial sector structures in the world's largest financial markets serve as important models for TSE policymakers. In those markets, clear trends have been evident over the past few decades. These countries have seen an erosion of the historic distinctions between different types of financial institutions and financial products, and the easing of many regulatory barriers to activities outside financial institutions' traditional lines of business. The result of these trends has been the emergence of diversified financial services conglomerates that can conduct a broad range of financial activities, including commercial banking, securities, funds management and, most recently, insurance.<sup>2</sup>

In many TSEs there exists a tendency to adopt a financial sector structure that entails the immediate emergence of financial conglomerates, in universal bank form or otherwise. This tendency not only reflects developments in the largest markets, but also is consistent with the existing high degree of concentration in TSE financial sectors, where large state-owned banks dominate the financial system. Policymakers may attempt to ascribe to these banks virtually all roles in the recast financial sector. The intent of this section is to assess the consequences of a financial sector structure envisioning the immediate emergence of large financial

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<sup>2</sup> This paper defines financial services conglomerates (or more succinctly, financial conglomerate) as any financial institution that conducts more than lending and deposit-taking, whether directly or through subsidiaries. One form of financial conglomerate is the truly "universal" bank, which conducts the full range of financial activities in a single legal entity. In another form, certain activities (most commonly insurance underwriting) are conducted through subsidiaries. Still another variant is where the parent is not a bank, such as in a holding company structure.

conglomerates which play extensive roles in all financial markets. Is this path consistent with achievement of the varied objectives of regulatory policy?

In response to this question, the following line of reasoning is adopted. By definition, banks have a key role to play in fulfilling the fundamental objectives. If banks can be put on a financially sound footing, and can maintain their financial soundness, most fundamental objectives of bank regulation are likely to be achieved without further extraordinary governmental intervention.<sup>3</sup> Limited governmental resources can be directed toward other uses. On the other hand, if financial sector structure is to be based on financial conglomerates, the existing banks will form the core of these conglomerates, and those banks will be relied upon to play the lead role in pursuing transitional objectives. Should this role impair banks' financial soundness, governments may be forced unexpectedly into extraordinary interventions to meet the obligations of failing banks, at a potentially destabilizing fiscal or monetary cost. Moreover, the failure of such banks would likely jeopardize achievement of transitional objectives by threatening the operations of the fledgling capital markets and disrupting key components of the bank and enterprise privatization process. Therefore, in adopting a policy framework allowing the immediate emergence of financial conglomerates, policymakers must be cognizant of the incremental obstacles to potential bank viability inherent in such a structure.

### **Key Issues for Financial Conglomerate Viability**

With the evolution of banks into financial conglomerates, they will be expected to pursue transitional objectives by participating in the financing and administration of the restructuring and privatization of enterprises. The resulting expansion in the scope of activities of banks and the wider variety of risks they incur must be evaluated in the context of i) managerial and institutional capacity, and ii) the capacity for effective financial market supervision.

#### **o Managerial and Institutional Capacity**

Probably the most important determinant of the soundness of a financial institution is the quality of its management. But with few exceptions among TSEs, bank managers have little

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<sup>3</sup> This paper does not address the extraordinary governmental intervention required to recapitalize insolvent banks, and thus put banks on a financially sound footing initially.

experience running large financial organizations subject to market forces. Their ability to comprehensively evaluate financial and operational risk is not well developed. An expansion of banks' scope of activities and riskiness will magnify the challenge facing management. Large, diverse financial conglomerates may be inconsistent with existing management capacity.<sup>4</sup>

The task facing management is exacerbated by banks' lack of institutional capacity. Accounting and data processing systems are not in place. Internal controls exist in only piecemeal fashion. Management information systems are rudimentary, and their reliability is compromised by the lack of accounting and internal control integrity. As a consequence, institutional capacity may not adequately support existing operations, much less a substantial expansion of banks' activities. Management's efforts would best be employed reorienting banks' policies, procedures and processes toward basic banking operations in a market economy.

Should policy precipitate an expansion of banks' activities, the greater number of customer classes and wider range of roles played by banks in the financial markets will increase the extent to which they confront situations involving potential conflicts of interest. Conflicts will arise between the interests of the bank and its customers, and between various classes of customers (e.g. depositors, trust beneficiaries, securities purchasers, borrowers, securities issuers). Conflicts of interest pose substantive operational risks which are normally contained by rather sophisticated institutional procedures intended to segregate information flows and decision-making responsibilities. Such procedures do not exist in TSE banks and will not easily be adopted. As a result, the operational risks arising from the greater incidence of situations involving conflicting interests may threaten the integrity and potential viability of banks.<sup>5</sup>

As noted, to fulfill transitional objectives banks will be asked to participate extensively in the capital markets. While some capital market activities may be viewed as roughly equivalent to traditional bank lending activities (e.g. investment in bonds), extensive participation in the

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<sup>4</sup> The quality of management will be influenced by incentives arising from the nature of bank ownership. Sound management may be threatened where policymakers permit controlling ownership of financial conglomerates by non-financial firms.

<sup>5</sup> The incidence and consequence of conflict situations will be greater still should policymakers permit controlling ownership of financial conglomerates by non-financial firms.

capital markets, and particularly the equity market, will expose banks to new and substantial risks. Equity holding are more difficult to value than are loans or bonds, and their values are more volatile.<sup>6</sup> Beyond the difficulty of valuation, equity holdings give rise to substantial, perhaps unmanageable, interest rate and liquidity risks.<sup>7</sup>

In pursuing transitional objectives, banks may be left with sizeable direct equity holdings, the consequence either of the conversion of enterprise debt into equity, or the acquisition of equities during the enterprise privatization process. Banks also may find themselves indirectly exposed to equity risks where they finance the acquisition of state-owned equities by managers or other private sector investors, and when they sponsor equity mutual funds. These exposures, beyond presenting substantial financial risks, will compound the demands placed on bank management, and will exacerbate the incidence of conflict of interest situations. To the extent that bankers are asked to play the role of shareholder in non-financial firms, they are distracted from the priority task of establishing and managing soundly functioning banks. To the extent that banks are asked to play the role of investor, underwriter, distributor and funds manager in the equity securities markets, the potential for corruption and abuse of conflicts of interest will be increased substantially.

#### o Supervision Capacity

The capacity for effective financial sector supervision in most TSEs is limited. Managers of supervisory agencies are struggling with organization, recruitment and training. Some have inherited a large complement of unqualified individuals. Others are starting from scratch. Where the agency is part of the central bank or finance ministry, these efforts take place in the context of the reorganization of much larger institutions with diverse and conflicting goals. In most cases, supervisory processes have yet to be developed. The procedures and processes necessary for off-site analysis, on-site inspections, enforcement and failure resolution are not in place.

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<sup>6</sup> Assessing the value of a performing loan requires a determination that sufficient cash flow will continue to be generated to service the debt over its life. Assessing the projected value of the borrower's equity over the same period cannot be accomplished with any comparable degree of certainty. Even an assessment of a non-performing loan supported by collateral is more assured. Only in the case of an unsecured non-performing loan is the task of evaluation comparable to that for the equity of the firm.

<sup>7</sup> To the extent that equity holdings exceed the bank's capital, they may be funded by interest bearing liabilities. No ready means exists to manage the resulting interest rate exposure. Similarly, a portfolio of TSE equity securities is likely to be illiquid.

The difficulty in achieving effective supervision is compounded by the state of development of banks and the financial markets. Since accounting and management information systems are poor and lack transparency, supervisors cannot rely upon the routine availability of accurate information regarding individual transactions or overall risks. Since the financial markets are underdeveloped and subject to many distortions, assessing the riskiness of transactions is difficult. Since ownership of many assets is changing, and shareholdings in bearer form are common, supervisors are hard pressed to determine linkages among banks, managers, major shareholders, and related non-financial firms. Under conditions such as these, the ability to effectively supervise banks is limited.

An expansion of the scope of banks' activities at this time will exacerbate the demands placed on the agency responsible for effecting the consolidated supervision of the institution, regardless of the precise form of financial conglomerates envisioned in each country.<sup>8</sup> For example, where policy permits universal banks, bank supervisors either need to supervise all financial services activities, or oversee the work of specialized functional supervisors responsible for supervision of certain activities conducted by the universal bank. Where policy requires that banks conduct some activities through subsidiaries, the bank's exposure to risks incurred by its subsidiary cannot be limited to its investment in that subsidiary.<sup>9</sup> Again, bank supervisors either need to directly supervise the subsidiary, or oversee the work of specialized functional supervisors. Finally, where the conglomerate is structured such that the parent is not a bank, the exposure of banks to risks run by non-bank financial institutions within the conglomerate would be constrained by "firewalls" intended to limit access by non-banks to the capital of the bank. But in practice such firewalls are not likely to be effective, and again the bank supervisors have to oversee the work of other supervisors.<sup>10</sup>

As the scope of activities and diversity of banks expand, the nature of bank supervision changes. It has been the experience in the larger financial markets that supervisors can rely less on prudential rules to adequately control overall risk in financial conglomerates. Supervision of these diverse institutions is more dependent on qualitative assessments of

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<sup>8</sup> The principle of consolidated supervision is a basic tenet of internationally accepted bank supervision practice.

<sup>9</sup> In times of crisis, banks usually are compelled to extend additional credits to the subsidiary.

<sup>10</sup> There exists considerable skepticism regarding the potential effectiveness of firewalls in the larger financial markets; firewalls tend to break down just when they were designed to become operative. In the words of a prominent U.S. bank supervisor, firewalls become "walls of fire".

institutionalized risk management and control systems, and on assessments of capital adequacy in terms of the reported and perceived overall riskiness of the institution.<sup>11</sup> But as noted, such systems generally do not exist in TSE banks. This lack of information integrity and transparency will preclude supervisors' ability to assess the overall riskiness and financial condition of the conglomerate. In contrast, banks operating in a limited number of markets or with a limited role in those markets can be supervised more readily by the application of prudential rules designed to limit risk and ensure the maintenance of a certain level of liquidity, reserves and capital. Determining compliance with prudential rules can be accomplished by supervisors who have a basic level of training and experience. Thus, the rapidity with which effective bank supervision is implemented can depend substantially on the nature of the banks to be supervised.

To conclude, the design of financial sector policy should promote achievement of both fundamental and transitional objectives. There are numerous substantive obstacles to the prospective financial soundness and viability of financial conglomerates in the TSE environment. Effective bank supervision cannot be relied upon to prevent problems that may arise as banks attempt to assume a vastly expanded role in the financial sector. Given these constraints, a strategy that envisions the immediate emergence of large, diverse financial conglomerates, and that relies on those institutions to achieve all financial sector objectives, may prove unsuccessful. Policymakers might best give consideration to alternative financial sector structures.

## **V. AN ALTERNATIVE APPROACH TO FINANCIAL SECTOR POLICY**

This section proposes an alternative approach to financial sector development during the early years of transition. In broad terms, it would promote the role of banks, funded primarily by deposits, in achievement of the fundamental objectives, and promote the role of non-banks, funded with liabilities other than deposits, in achievement of transitional objectives. After some period of time, the roles of both sets of institutions could converge.

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<sup>11</sup> The adoption of an international standard for capital adequacy by the Basle Committee on Banking Supervision was a significant first step in this direction.

The policies proposed here could be affected under a variety of legal arrangements. Particularly where financial sector legislation has yet to be revised, these policies could be reflected in the new legislation. Alternatively, these policies largely could be proscribed under the prudential rules adopted by supervisors, provided that the legal framework grants bank supervisors the power to restrict the scope of operations of new banks, and to narrow the scope of operations of existing banks. As such, this policy framework can be compatible with legislation permitting financial conglomerates and universal-type banking. In effect, it would guide the manner in which such institutions emerged.

### The Nature and Role of Banks

Policy with regard to banks would aim to promote achievement of the fundamental objectives by promoting the financial soundness of the banking system, thereby minimizing the potential for required extraordinary governmental interventions. Through the use of strict licensing procedures, only a limited number of banks would be permitted. Banks would be granted the exclusive right to raise funds through instruments labeled "deposits". Deposits would be protected by a government-backed protection program. It would be mandatory for the savings and transaction accounts of households to be covered by the deposit protection program, and thus banks would have exclusive right to offer such accounts to households. Banks and the central bank would share responsibility for ensuring the integrity of the payments system settlement process. Prudential rules would limit the risks banks could run and require the maintenance of relatively high liquidity, reserves and capital. (The Appendix provides a detailed listing of sample prudential rules.) Adherence to prudential rules and sound banking practice would be subject to close supervision. Ownership and managerial linkages between banks and non-banks, both financial institutions and enterprises, would be restricted initially.<sup>12</sup>

Policy would strive to balance the tradeoffs involved in permitting banks to play as great a role in the processes of transition as is consistent with financial soundness. This tradeoff is most important when determining the role of banks in corporate finance. Corporate lending

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<sup>12</sup> The small cooperative institutions encountered in most TSEs would have to form and be members of one of a limited number of "central institutions", each of which would be licensed and regulated as a bank. The central institution would clear and settle payments for its members, act as lender of last resort, provide technical assistance and bear responsibility for their prudent operation. While cooperatives would have the same powers as would banks, their activities might be restricted either by the central institution or by the bank supervisors.



in the TSE environment is highly risky. To foster sound lending, loan portfolios must be well diversified, mostly secured and mostly short term. Prudential rules would mandate such practices. Loan diversification would be promoted by application of a relatively conservative large exposures limit<sup>13</sup>. Other prudential rules would establish conservative collateral and maturity requirements. As a consequence, banks' role would be to offer primarily secured working capital finance to small and medium scale companies. Credits to larger borrowers could be arranged on a consortium basis. By utilizing the best available credit skills, such lending might be conducted without systematically jeopardizing financial soundness.

Banks would provide a safe place for the risk adverse to maintain their deposits in virtually unlimited amount. The fundamental objective of deposit safety would be assured through government backing of a deposit protection program. The essential characteristics of the program are that it apply to all banks, that its coverage limits be relatively high, and that it have unequivocal government backing. To reflect the value to depositors of the protection provided by the government, and to minimize moral hazard, interest rates payable on bank deposits would be restricted by regulation. Deposit interest rates generally would not exceed those on government paper of comparable maturity. Moreover, deposit interest rates might be held to slightly negative real terms, in part as a means to promote the growth of non-banks.<sup>14</sup>

Banks' would be permitted to conduct only limited activities in foreign currencies. Funding and investment in foreign currencies would be subject to conservative limits on open positions (precluding mismatches in currencies and in time). To the extent that banks are not required by regulation to on-lend foreign currency deposits to the central bank, permissible foreign currency investments would be prescribed. Lending in foreign currency would be limited to borrowers clearly generating sufficient foreign currency revenues to service the debt.

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<sup>13</sup> Large exposure limits, or lending limits, establish the maximum amount that a bank can lend to a single obligor or related group of obligors. The limit is typically expressed as a percent of the bank's capital. See the Appendix.

<sup>14</sup> This paper presumes that government will protect most deposits, even where no explicit coverage exists. Adopting explicit deposit protection coupled with interest rate regulation for protected accounts is employed as an equitable means of passing on to depositors part of the cost of this protection. The value of such protection might be great given the level of financial market risks, conceivably justifying negative real interest rates.

Banks' role in the capital markets would be limited. Banks would be permitted to invest in, trade, and lend against government securities. Banks would be permitted to investment in corporate debt securities, subject to the exposure limits applicable to lending, and would be permitted to lend to securities firms against such securities issued by third parties. Investments in or lending against equities would be permitted only in exceptional circumstances. Banks could take equities as part of the renegotiation of bad debts, provided that the equity was booked at a nominal value and was sold within a short period. Underwriting, distribution, and trading of corporate debt or equity securities would be prohibited. Banks would not be permitted to offer pooled investment management services (e.g. mutual funds).<sup>15</sup> With the prior approval of the relevant supervisors, banks could play certain fee-based agency and advisory roles, such as acting as corporate advisor on capital markets transactions, serving as a depository for mutual funds, or engaging in securities transactions on an agency basis at the request of a customer. Given these restrictions, banks would play virtually no formal role in the management of enterprises, and would fulfill only administrative roles in enterprise privatization process.

Banks' role in the insurance market would be limited. Banks would not be permitted to underwrite insurance. With the prior approval of the bank and insurance supervisors, banks would be permitted to distribute insurance products underwritten by others for a fee.

Additional prudential rules would serve to limit riskiness and ensure sufficient capital. Rules limiting interest rate mismatches would minimize the interest rate risk incurred by banks. Rules requiring maintenance of minimum levels of liquid assets would foster liquidity, and would serves as a trigger point for supervisory attention.<sup>16</sup> To minimize the risk of insolvency, banks would be subject to high provisioning requirements and high capital ratios.

Part of the earnings necessary to generate reserve and capital formation would be derived via the indirect subsidy banks receive from the government's protection of bank deposits, on which relatively lower rates of interest would be paid. The benefits of this low cost funding base would accrue directly to the banks, and no policy constraints would attempt to pass these benefits on to certain classes of borrowers. The higher spreads will enable banks to

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<sup>15</sup> Individual fiduciary services could be offered.

<sup>16</sup> Simple asset-based liquidity rules will likely prove sufficient, at least until the money markets become more highly developed.

build high mandatory provisions and capital, and to generate sufficient returns on capital. Consistent with the goal of financial soundness, tax policy would promote the accumulation of provisions by banks.

As a consequence of this policy approach, banks would be simpler and thus better matched to the skills of managers and institutional capacity. Limits on banks' scope of activities would reduce the incidence of conflict of interests and promote increased transparency. Rules designed to preclude direct or indirect exposure to equity markets would preclude many potential conflicts of interest, prevent the assumption of substantial financial risks, minimize the potential for systemic losses in the capital markets from spreading to the banking sector, and reduce the burden on limited managerial resources arising from banks' role in enterprise governance and management.

Under this policy approach, bank supervision can rely more upon the application of basic prudential rules regarding asset riskiness and diversification, liquidity, provisioning and capital, and less on the qualitative assessments necessary to gear capital requirements to the perceived riskiness of more complex institutions engaged in a wider range of activities. With a modest skill base bank supervisors are likely to be able to make substantial progress in achieving effective supervision. To support early implementation of effective bank supervision, banks would have to be audited annually by independent and competent auditing firms acceptable to the supervisors. The auditors would initially focus on the development of sound accounting practices and internal controls, would be required to perform standardized testing to determine compliance with prudential rules, and would play a role in assisting the bank in implementing corrective action when violations of law or non-compliance with prudential rules were detected. With this cooperative approach, the banking system is more likely to be effectively supervised within a reasonable period of time.

### The Nature and Role of Non-Banks

While banks would be limited in number and highly regulated, policy would promote the proliferation of non-bank financial institutions, some forms of which would be subject to little or no regulation. Non-banks could conduct any type of financial service activity, with the exception that they would not be permitted to fund themselves via instruments labeled "deposits". These institutions would not be permitted to use the word "bank" in their title;

rather they might be known legally as "finance companies", "industrial loan companies", "trust companies", "mutual funds", "private investment companies", "insurance companies", etc.<sup>17</sup>

Non-banks would be permitted to raise retail funding, provided that retail interest-bearing funding takes the form of "investment certificates" or similarly-labeled instruments having a fixed maturity of at least one month. The funding of non-banks would not be covered by the government-backed protection program, and explicit notification that the instrument is not protected by the government would be required.<sup>18</sup> Interest rates would be set by the market, serving both to promote the emergence of non-banks and to minimize any adverse consequence on savings mobilization arising from interest rate restrictions on bank deposits.

Non-banks would be granted considerable latitude in financial market activities. Non-banks that deal only with wholesale customers (including enterprises), or that accept funding from less than a small number of individuals, would be virtually unregulated. Non-banks that solicit funding from individuals more broadly would be subject to regulation and varying degrees of supervision. Supervision could in many cases be organized around self-regulatory arrangements designed to promote acceptance of various types of institutions by investors. Generally, entry level capital requirements would be minimized to promote the emergence of non-banks.

Policy would promote the role of non-banks in achieving transitional objectives. For example, non-banks would be expected to play a principal role in the enterprise privatization process, primarily by sponsoring open and closed-end mutual funds, or similar such vehicles, that solicit funds for investment in the shares of newly privatized enterprises. The regulation of such entities would focus on adequate disclosure, particularly with regard to any conflicts of interest, and fair marketing practices. Open-ended funds would be subject to diversification rules.<sup>19</sup> Non-banks similarly could solicit funds for long term investment lending to enterprises, perhaps via the purchase of convertible or equity-linked bonds

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<sup>17</sup> The fundamental role played by insurance companies may more closely parallel that of banks, and thus insurance companies should be subject to specialized regulation and supervision. Insurance company regulation and supervision is not addressed further in this paper.

<sup>18</sup> To promote this policy, non-banks that accept interest-bearing funding might be required to use standardized or pre-approved contracts that clearly differentiate the instrument from a bank deposit.

<sup>19</sup> See EC Council Directive 85/611 for appropriate diversification rules.

issuances. Non-banks would be expected to function as stockbrokers and would operate stock exchanges.<sup>20</sup>

Non-banks could offer payment services to corporate entities. However, most non-banks would have to settle their payment transactions through a bank. Only certain individual non-banks would be permitted to settle directly, subject to the approval of the central bank and representatives from the bank-based organization responsible for managing the settlement process.

### Relationship of Banks, Non-banks and Government

A key challenge in balancing the achievement of fundamental and transitional objectives under this policy framework is to preclude losses incurred by non-banks from either jeopardizing the financial soundness of the banking system, or being of such a large scale that direct governmental intervention is required on behalf of failing non-banks. Several policies are critical to achieving this balance. First, the customers of failing non-banks would be expected to bear fully the losses associated with that failure. Second, policy applicable to non-banks would attempt to limit market concentration to minimize the potential that a non-bank grows so large that its imminent failure would itself represent a systemic threat requiring extraordinary governmental intervention. Third, most ownership and management linkages between banks and non-banks would be precluded, both to minimize direct financial and moral linkages between banks and non-banks and to ensure arms-length decision making regarding transactions. Finally, all bank transactions with non-banks would be subject to the same exposure limits that apply to corporate entities.<sup>21</sup>

Despite these policies, a considerable volume of bank/non-bank transactions will occur. Banks will need to settle payment transactions for non-banks, and will likely engage in substantive money market transactions with non-banks. As such, banks may have to cover the potential illiquidity of non-banks. These advances, in addition to other credit exposures, would be put at risk if the non-bank becomes insolvent. The insolvency of non-banks can

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<sup>20</sup> Since banks would not be permitted to be clearing members of stock exchanges, by implication, government securities would not be traded on stock exchanges under this policy framework.

<sup>21</sup> With possible exceptions for short term money market transactions.

potentially lead to the insolvency of a bank and threaten banking system financial soundness. As such, an important function of banks would be to monitor their credit exposures to non-banks and to promote the prudent operation of their non-bank clients. Initially at least, banks might insist that most operations with non-banks be conducted on a secured basis.<sup>22</sup>

After managerial and supervisory skills are developed, the financial markets become better established, and market turmoil subsides, cross-ownership restrictions between banks and other financial institutions gradually could be lifted to allow the emergence of diversified financial services conglomerates. At the same time the activities of the various supervisory agencies would have to be harmonized in order to ensure the consolidated supervision of those institutions.

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<sup>22</sup> For example, clearing and settlement conducted on behalf of non-banks could be supported by pledged government securities.

## **APPENDIX**

### **Sample Prudential Framework for Banks**

**This prudential framework reflects the policy proposals set forth in the paper. It is designed to promote the financial soundness of the banking system over the transitional period, defined here as five years, by limiting banks' overall riskiness and promoting the maintenance of adequate levels of reserves and capital. This framework would be established under legislation and the rules of the supervisor.**

#### **Financial Sector Structure**

- o Banks would constitute a clearly defined and delineated class of financial institution. Ownership of banks by other legal entities (or related individuals and legal entities) would be limited to 25% of the bank's shares. Limited exceptions to this limit might be permitted, such as in the case of ownership by a well-supervised foreign bank. Beginning in 5 years, this limit would be phased out with respect to ownership by other financial institutions.**
- o Banks would be allowed only limited ownership interests in non-bank financial institutions, such as securities, funds management and insurance companies, primarily to facilitate divestitures that might be required for banks to conform to the regulatory policy framework outlined in this paper. Investments in and loans to such companies would be limited to 10% of bank capital per institution, and 25% in aggregate. The ownership interests of a bank would be limited to 20% of the non-bank institution's capital. Directors and managers of banks could not be employed by or serve as directors of non-bank financial institutions, and vice versa. These limits and restrictions would be phased out beginning in 5 years.**
- o Investments in and loans to non-consolidated non-bank financial institutions would be deducted from capital when assessing compliance with the minimum capital standard.**

- o Banks would be prohibited from investing in institutions whose shares are in bearer (non-registered) form.
- o Banks' shares would have to be issued in registered form.
- o Banks would require the prior approval of the supervisors to invest in non-bank financial institutions, to open new branches, and for all merger and acquisitions transactions.

### Credit Risk and Asset Powers

Generally, banks would be permitted to hold a diversified portfolio of small and medium scale corporate loans<sup>23</sup> and consumer loans.

- o The large exposures limit,<sup>24</sup> applicable to each obligor (or group of related obligors) would be 15% of banks' capital, with a 5% sub-limit for unsecured lending. A phased-in increase to 25% and 15% respectively would begin after five years.<sup>25</sup> Qualifying collateral would be defined, and would include current accounts receivable, current inventories, and in the case of securities firms, corporate bonds issued by third parties.
- o The sum of all per-obligor credit exposures in excess of 10% of banks' capital would be limited to 400% of banks' capital. A phased-in increase to 800% would begin after five years.<sup>26</sup> All such exposures would be reported periodically to the supervisors.
- o Lending for the construction or acquisition of commercial and industrial real estate lending would be subject to an aggregate limit of 200% of banks' capital.

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<sup>23</sup> Including similar instruments otherwise defined legally as securities or financing leases.

<sup>24</sup> On and off balance sheet exposures.

<sup>25</sup> Under a proposed Directive of the European Commission, large exposure would be limited to 25% of banks' capital. The EC does not propose a sub-limit for unsecured lending.

<sup>26</sup> The proposed EC limit is 800%.



Conservative maximum loan-to-value limits would be established for all forms of real estate lending.

- o The holding of equity securities of non-financial firms would be prohibited except when taken to satisfy previously contracted debts. Such holdings would be booked at a token value, unless traded on a regulated stock exchange, in which case they would be booked at the lower of cost<sup>27</sup> or market. Such holdings would have to be divested within 1 year.
- o The financing of the purchase of shares by customers would be limited to 50% of the cost of the shares (which would have to be held as collateral), and limited in aggregate to 50% of banks' capital. Aggregate financing for the shares of any one firm would be limited to 25% of the firm's shares.
- o Lending to managers, supervisory board member and shareholders would be limited to an aggregate limit of 10% of capital.
- o Underwriting, distribution and trading of corporate debt and equity securities would be prohibited.

#### **Capital Markets Activities**

- o Pooled investment management would be prohibited. Banks could offer such fiduciary services only on an individual, segregated basis.
- o Prior approval would be required to offer advisory services, act as depository for mutual investment funds, or conduct agency transactions on behalf of customers.

#### **Insurance Activities**

- o Underwriting insurance products would be prohibited. With prior approval, banks could sell insurance products underwritten by others.

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<sup>27</sup> Where cost is equivalent to the nominal amount of debt written off.

## **Reserves and Capital**

Generally, lending would be subject to high provisioning requirements, and a conservative minimum capital rule would be applied. Bank supervisors would have the power to mandate capital in excess of the minimum when considered necessary to support the operation of the bank.

- o A general reserve of 2% of total loans would be required.
- o Specific reserves against non-performing loans (interest or principal past due for 90 days or more) would be created progressively such that the reserve equals 100% of the exposure (face amount less 75% of the estimated realizable value of tangible collateral) no later than 2 years after the loan becomes non-performing. Reserves would be required earlier should the likelihood of loss become apparent.
- o Prudential rules would define situations presumed to constitute non-performance. Rollovers of interest would be limited to 6 months interest in any 2 year period. Banks would be required to maintain documentation relating growth in working capital lines to non-distressed increase in borrower's requirements (e.g., increased sales).
- o The minimum capital standard would utilize the features of the Basle accord (risk-weighted assets and off-balance sheet exposures, and conservative definition of capital). The minimum ratio would be set initially at 12%, and would be phased down to 8% beginning in five years.<sup>28</sup> Alternatively, an 8% capital requirement could be employed, and weights of 150% applied to corporate lending.
- o In principle, the capital standard must be met on a continuous basis.
- o Dividend payments would be subject to restrictions to ensure maintenance of adequate capital. For new banks, no dividends could be paid in first three years of operation unless approved in exceptional circumstances by the supervisors. No dividends could

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<sup>28</sup> The Basle minimum is 8%. Many G-10 countries require higher levels for most banks.

be paid if the supervisors have notified the bank that its loan loss provision is inadequate, or if the general reserve has not been established or the minimum capital standard is not met.

### **Interest Rate Risk**

- o Fixed rate loans of over two year maturity would be limited to 100% of capital (net of fixed assets) and 80% of long term funding, which would include savings accounts without fixed maturity. Longer dated asset maturities could be limited in declining proportion to long term funding.

### **Foreign Exchange Rate Risk**

- o Open foreign currency positions would be limited to 5% of capital per currency. The sum of the absolute value of all open positions would be limited to 15% of capital. Interest rate mismatches in foreign currencies would have to be confined to less than six months forward. Beyond six months forward, all positions must be matched.
- o Foreign currency lending would be restricted to sound borrowers generating sufficient foreign exchange to cover debt service, and would be limited in aggregate to 50% of capital.

### **Liquidity**

- o Banks would be subject to an asset based liquidity requirement. Twenty percent of banks' assets would held as cash, sight deposits in banks, or in government paper (or equivalent liquid paper).

### **Interest Rates on Protected Deposits**

- o Interest rates on banks deposits would be restricted. At highest, they would be equivalent to the rate on government paper of comparable maturity and rate structure.

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